Mario Draghi: Addressing the causes of low interest rates

Introductory speech by Mr Mario Draghi, President of the European Central Bank, at a panel on "The future of financial markets: A changing view of Asia" at the Annual Meeting of the Asian Development Bank, Frankfurt am Main, 2 May 2016.

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The mandate of each central bank is phrased in strictly domestic terms. But in an open and integrated international economy, the challenges we face are often fairly similar across jurisdictions. Over the past few years, one particular challenge has arisen across a large part of the world. That is the extremely low level of nominal interest rates.

Today, 18% of the global economy, weighted by GDP, operates in an environment of negative central bank policy rates, and the proportion rises to 40% if we include countries with zero to 1% rates.

Very low rates are not innocuous. They put pressure on the business model of financial institutions – banks, pension funds and insurance companies – by squeezing interest income. And this comes at a time when profitability is already weak, when the sector has to adjust to post-crisis deleveraging in the economy, and when rapid changes are taking place in regulation.

Low real returns also affect the income of pensioners, who are a growing constituency in most advanced economies. Their consumption in retirement depends precisely on the return they get on their savings. Likewise low rates slow the rate of accumulation of pension assets of those not yet retired, which is again relevant as a larger cohort moves towards retirement.

There is a temptation to conclude that since very low rates generate these challenges, they are the problem. But they are not the problem. They are the *symptom* of an underlying problem, which is insufficient investment demand, across the world, to absorb all the savings available in the economy.

It is this phenomenon – the global excess of savings over profitable investments – that is driving interest rates down to very low levels. And so the right way to address the challenges raised by low rates is not to try and suppress the symptoms, but to address the underlying cause.

This requires that we tackle both the long- and short-term drivers of lack of demand, and that we draw for that purpose on both monetary policy and other types of policy.

The long-term perspective

From a long-term perspective, nominal bond yields have been on a declining trend in all major economies since the 1980s. This is in part a welcome development, as it reflects the success of monetary policy in overcoming inflation. That has reduced not just expected inflation, but also the inflation risk premium – the cost levied by lenders to protect them against uncertain price changes.

But the decline in nominal yields has also been driven by a fall in *real yields*, which is the real return generated by the balance of saving and investment in the economy.

A temporary period of policy rates being close to zero or even negative in real terms is not unprecedented by any means. Over the past decades, however, we have seen long-term yields trending down in real terms as well, independent of the cyclical stance of monetary policy.

The drivers behind this have been, among others, rising net savings as ageing populations plan for retirement, relatively less public capital expenditure in a context of high public indebtedness, and a slowdown in productivity growth reducing the profitability of investment.

One study finds such factors can account for around 400 basis points of the 450 basis points fall in long-term real interest rates over the past 30 years.[1]

The forces at play are fairly intuitive: if there is an excess of saving, then savers are competing with each other to find somebody willing to borrow their funds. That will drive interest rates lower. At the same time, if the economic return on investment has fallen, for instance due to lower productivity growth, then entrepreneurs will only be willing to borrow at commensurately lower rates.

On both counts, it is structural factors that have lowered the real return on investment. And since we operate in a global capital market, this has exerted downward pressure on returns on savings everywhere.

The role of Asian economies in this story has been well-documented, for instance in the "global savings glut" thesis.[2]

But today the euro area is also a protagonist. We have a current account surplus over 3% of GDP, and our largest economy, Germany, has had a surplus above 5% of GDP for almost a decade.

In the past, countries with such surplus positions may have been able to easily export excess savings towards countries willing to borrow them at higher rates. This would have prevented domestic interest rates from falling, as would otherwise have been the case. And that would have been good for the global economy as saving flowed from ageing, slower growth economies to those with younger demographics and higher investment needs.

But in a world where real returns are low everywhere, there is simply not enough demand for capital elsewhere in the world to absorb that excess saving without declining returns.

So the long-term answer to raising real rates of return must be a structural rebalancing of global saving and investment. And since demographic-related saving is likely to remain high, that has to come through raising demand for capital. This is why structural reforms are so important today. They are key to raise productivity growth and hence make investment more attractive.

The ECB Governing Council, the European Council and the European Commission have repeatedly called for such structural action in Europe. It is also precisely the agenda that the G-20 has been advocating. Progress has been made in some countries, especially those in the euro area that suffered the crisis worst. But on the whole it is advancing too slowly.

The short-term perspective

Where does monetary policy enter the picture?

While structural factors drive long-term real rates, monetary policy influences interest rates over the short-term. But it does so only at the margin: central banks steer market rates *relative* to the level dictated by those structural forces. This alters the relative attractiveness of saving versus spending, and in doing so helps keep output around potential and ensures price stability.

Today, faced with a persistent output gap and too-low inflation, our monetary policy is stimulating the economy by steering market rates below their long-term levels. And since those long-term rates have fallen very low, it is inevitable that market rates have fallen to

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1 Rachel, L. and T. Smith (2015), *"Secular drivers of the global real interest rate",* Bank of England Staff Working Paper No. 571.

2 See Bernanke, B. (2005), *"The Global Saving Glut and the U.S. Current Account Deficit",* Sandridge Lecture, Virginia Association of Economics, Richmond, Virginia, Federal Reserve Board March 2005.

very low and even negative levels for an extended period of time to achieve the right level of demand support.

This has been the case not just for the euro area, but also for Japan, where central bank policy rates have been near zero since the mid-90s; for the US, where they have stayed near zero since 2008 and have been raised only once since, at the end of last year; and for the UK, where policy rates have been just above zero for 7 years now.

If central banks did not do this – i.e. if we kept interest rates too high relative to their real levels – investing would be unattractive, because the cost of borrowing would exceed the return. So the economy would stay stuck in recession. Conversely, by holding market rates below the real rate of return, we encourage the investment and consumption that is needed to bring the economy back to potential. That in turn creates the conditions for monetary policy to eventually normalise.

It might seem at first glance that this policy is tantamount to penalising savers in favour of borrowers. But in the medium-term, expansionary policy is actually very much to the benefit of savers.

For a start, savers can still earn satisfactory rates of return from diversifying their assets, even when interest rates on deposit and savings accounts are very low. For example, US households allocate about a third of their financial assets to equities, whereas the equivalent figure for French and Italian households is about one fifth, and for German households only one tenth. By contrast, German households keep almost 40% of their assets in cash and deposits, and French and Italian households approximately 30%. The equivalent number is less than 15% for US households.

But more fundamentally, it is key to appreciate that whatever financial assets savers hold, they always own a claim on the output of the economy. So their interest is ultimately the same as that of the economy as a whole.

If central banks did not act to bring the economy out of slump, what would happen to those claims? Not only would output rise more slowly towards potential, but more importantly potential itself would be eroded. Since unemployment would remain high for longer, people would lose their skills; and as investment would remain subdued for longer, the productive capacity of the economy would suffer lasting damage. A crisis-induced loss of output would then become permanent, and the real wealth of savers would inevitably be lower.

In other words, while low interest rates might appear to create a conflict between creditors and debtors, this is not true in the aggregate, and it is certainly not true over the medium-term. Overall, savers and borrowers in fact have the same interest: that the economy returns to potential without undue delay and grows sufficiently strongly to generate enough income for both. That, in final analysis, is the only way to truly protect the long-term interest of savers.

Thus the second part of the answer to raising rates of return is clear: continued expansionary policies until excess slack in the economy has been reduced and inflation dynamics are sustainably consistent again with price stability. There is simply no alternative to this today.

The only potential margin for manoeuvre is in the composition of the policy mix, that is, the balance of monetary and fiscal policy. In fact, those advocating a lesser role for monetary policy or a shorter period of monetary expansion necessarily imply a larger role for fiscal policy to raise demand and close the output gap faster.

Conclusion

Let me sum up.

The global low interest rate environment is a symptom of challenges in the world economy, not its cause. If interest rates are to rise again to sustainably higher levels, it is those underlying causes that need to be addressed. This is true at a global level, and it is true in the euro area.

In the euro area, we need expansionary macroeconomic stabilisation policy to support demand, starting of course with monetary policy. That will allow inflation to return to our objective and, in time, for policy interest rates to rise back to their long-term levels.

But monetary policy cannot raise long-term real rates. That can only be achieved by structural reforms that elicit a structural rebalancing of saving and investment. Higher real returns on savings must come through decisive action on the supply side.

In this context, there is also a third type of policy that would support both demand in the short-term and supply in the medium-term, and which is unique to Europe. That is committed reform of euro area governance that can remove lingering doubts about its future.

There is little doubt that question marks over the future of the euro area, and the European Union in general, are contributing to uncertainty for individuals and firms, and that this can hold back consumption and investment. Removing this uncertainty will help boost consumption and unleash investment across the continent.

There is therefore no doubt in my mind that institutional reform in the European Union and of the euro area has genuine economic benefits. For all those who want to see a return to more normal levels of interest rates, this is an essential part of the solution.